Special Reports

Jury Still out on Jobs Tax Subsidy Programs

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> *In this article, Professor McIntyre reviews the targeted jobs credit program and the work incentive program. He notes that evidence regarding the effects of these two programs is still sparse, but that there is some indication that the principal impact of the programs has been on unemployed youths. He also notes that the programs do not appear to have been very effective in creating new jobs, and that workers who are eligible for the credit may be displacing other workers who would otherwise have been able to obtain employment. He concludes, however, that, despite its defects, the jobs tax subsidies provide a helpful counterweight to other tax-based incentives that favor investment in machines rather than people.*

Some economists believe that many Americans are out of work today because their prospective work product is not worth even the minimum wage. To create jobs for these "hard core" unemployed, Congress has made a generous offer to employers in the private sector of the economy through two tax credit programs: the targeted jobs tax credit (TJTC) and a similarly designed tax credit offered under the work incentive (WIN) program.

Under both programs, the federal government agrees to bear a part of the cost of wages paid to new employees who fall within one of several groups defined in the law.

The TJTC and WIN credits are 1978 revisions of previously enacted wage subsidy programs. The TJTC replaced a 1977 untargeted credit that was intended to reduce the unemployment rate during downturns in the business cycle. The WIN credit overhauls a 1971 program adopted in the hope of moving welfare recipients into productive employment. The wage subsidy under both programs is the same but the eligibility standards differ.

Empirical Evidence Is Sparse

Empirical evidence on the effectiveness of these programs is sparse, and some of what information exists is soft as meringue. We do know for certain, however, that far fewer employers have been accepting the government's wage subsidy offer than anticipated and most of those who did accept have used the programs to hire youths, generally for part-time or temporary jobs. We also have some sketchy data suggesting that the targeting mechanism is not working well. Apparently many employers are substituting subsidized workers for workers who are not within any of the targeted groups.

Policy conclusions from this fragmentary evidence are difficult to make. In my view, the WIN program is a small time operation, so narrowly targeted that it cannot have a significant impact on structural unemployment. Only historical accident has kept it from becoming a minor piece of the TJTC. The TJTC program, in contrast, potentially serves an unidentifiably large percentage of those traditionally classified as hard core unemployed. That potential apparently is not being fulfilled. The strong response of qualified youths to the TJTC, however, suggests that serendipity may have brought us the foundation for a workable youth employment program. Instead of spitting in the face of dame fortune, policymakers should study the practicality of abandoning the unfulfilled objectives of the TJTC and converting it into an explicit instrument to combat youth unemployment.

Alternatively, Congress could grapple again with the complex issue of targeting. Analysts who have studied the problem of structural unemployment are convinced that the present targeting mechanism of the TJTC is defective. Unfortunately, any replacement mechanism also will be defective, since policymakers can never obtain the detailed information on the potential productivity of unemployed and marginally employed persons necessary to fashion an economically efficient system for paying and withholding the wage subsidy. The most we should hope for is a somewhat less profligate subsidy for the disadvantaged.

How the Programs Work

The TJTC and WIN programs provide a tax credit to an employer hiring a new employee from the hard core unemployed groups equal to one-half of the first $6,000 [*308] of qualified first-year wages and one-fourth of second-year wages.

Since the amount of the wage subsidy paid by the government cannot be considered an employer business expense, an employer must reduce his deduction for wages paid by the amount reimbursed through the tax credit mechanism. Consequently, the subsidized employer is treated the same as other private parties who receive taxable payments from the government. The after-tax benefit of the credit to a corporate employer at the top 46% rate works out to approximately $1,600 for each $6,000 of eligible wages paid.

The "targeted" group for the TJTC includes many welfare recipients, disadvantaged Vietnam veterans under 35 years of age, handicapped persons undergoing vocational rehabilitation, certain disadvantaged exoffenders, disadvantaged young people aged 18-24, and teenagers participating in a cooperative education program. Most welfare recipients not covered by the TJTC are eligible for WIN.

To prevent wholesale substitution of existing workers for workers who qualify their employers for a wage subsidy, both TJTC and WIN were subjected to a cap. The cap limits the credit to 30% of all wages subject to the federal unemployment insurance tax paid in the year for which the credits are claimed. As a result of the cap, firms are permitted to hire approximately one subsidized worker for every two regular members of their work force. Small firms would bump against the cap very quickly. For example, a firm with only two employees before the credit will exceed the 30% cap when it hires just one eligible employee.

Scope of the Program

Between March, 1979, when the TJTC went into effect, and December of that year, 200,000 vouchers and 109,000 certifications were issued. To qualify for a credit under the TJTC program, a prospective employee must receive a voucher from the state employment security agency that confirms the individual's eligibility. The employer then must sign the voucher to confirm that the individual has been or will be hired; finally, the state agency issues the employer a certificate that can be used to claim the credit.

A similar system is used for WIN credits. The Department of Labor reported that 42,713 WIN credits were certified in fiscal 1979 and 26,224 in the first six months of fiscal 1980.

Currently, total certifications for the much larger TJTC program are running at approximately 280,000 a year according to Labor Department reports.

Labor Department officials warn that each certificate issued should not be constructed as representing a full-time, full-year equivalent job. Many of the certificates probably represent workers hired on a part-time or temporary basis. In addition, some certified individuals may never actually report for work.

Cost Have Been Modest

The costs of the credit programs are relatively modest. For 1979, Treasury estimates the tax expenditure for TJTC at only $15 million, about 10% of the $141 million estimate made by the CBO before the program came on line. The WIN tax expenditure is estimated at $50 million each in fiscal 1979 and 1980. Treasury staff members warn that the 1979 figures are problematic. For 1980, the tax expenditure has gone up to an estimated $140 million for the TJTC, still less than a third of the 1978 predictions.

Studies Are Underway

Studies underway at the General Accounting Office, the Congressional Budget Office and the Treasury Department should provide a clearer picture of the early performance of the tax credits. The Treasury Department is required by law to produce a report by next June 30 to help Congress determine whether or not to extend the credits beyond their expiration date of December 31, 1981. The GAO report, a draft copy of which was made available to the author, identifies the present targeting mechanism as a major cause of the low employer response to the credits.

The GAO study, which has not yet been formally approved by GAO, makes the key point that wage subsidy programs like the WIN and targeted jobs credits can only be effective if the principal cause of unemployment is downward inflexibility of wage rates. When a worker's productivity is so low that a private sector employer would not hire him at any price, a public service employment program, in which emphasis would be almost solely on skill-development, becomes the only feasible job creation mechanism.

An Indirect Youth Employment Program

Although the TJTC would appear to address a very wide clientele of hard core unemployed, about 84 percent of all certifications issued in 1979 were for disadvantaged youths (34 percent) and youths in cooperative education programs (50 percent). These are easily the most populous of the targeted groups, but the almost complete conversion of the TJTC into an indirect youth employment program is still somewhat surprising.

Whether or not the TJTC functions well as a youth employment program cannot yet be determined. Researchers at the Congressional Budget Office have some anecdotal evidence that many of the subsidized jobs found by qualifying youths are part-time or temporary – fast turn-over jobs in the fast food industry, for example. If these jobs can be used by young people as a springboard to full-time employment, the TJTC may be performing a useful function. Otherwise, a temporary job would provide only a temporary solution to youth unemployment. The Treasury Department has promised to focus on this set of issues in its report due next year. [*309]

An Informal Targeting System

Curiously, in a survey of firms conducted by the GAO, less than 5 percent of youths qualifying for the wage subsidy had actually gone through the certification process. GAO researchers speculate that many youths intentionally conceal their eligibility to avoid the stigma that might be attached to participation in the program. An equally plausible explanation is low employee knowledge about the TJTC. In any case, in view of this finding, the diligent efforts of the Labor Department to increase employer participation in the program may be counterproductive, making the program simply more costly, not more effective.

The low participation rate of qualified youths suggest the existence of an informal targeting mechanism, perhaps managed by the state employment officers who handle the certification procedures. Further evidence of informal targeting is the disproportionately high percentage of minority youths using the TJTC, about 50 percent for 1979. Perhaps this informal mechanism should be encouraged, especially in light of the very high rates of unemployment among young minorities. Understanding this informal mechanism should be a high priority of ongoing studies of the TJTC.

The Displacement Problem

Most academic concern about the credits has centered on the interrelated issues of displacement and targeting. Displacement occurs when workers hired because of the tax subsidies take positions that would have been filled without the credit. The effects of displacement are important both to policymakers desiring to make sure the taxpayers get value for the subsidy they are funding and to workers who lose– or do not get– jobs filled as a result of the subsidy.

Researchers at the GAO have some empirical evidence that displacement for the TJTC is high. From a mail survey of 1,000 firms, they concluded that approximately 13 percent to 25 percent of jobs taken by subsidized workers were new jobs created by the tax credit. This disturbing finding is very plausible, especially in a job market in which many unquestionably productive individuals find themselves out of work.

The theoretical solution to the problem of displacement is refined targeting. The GAO report contends, however, that the targeting provisions of current law give a powerful incentive to substitute workers just below the economically disadvantaged line for those just above it. Targeting by the group identity of individuals, the report claims, guarantees a high displacement rate.

The Results of Targeting by Group

According to the GAO report, targeting by group identity has two other negative consequences. Targeting by groups will always exclude large numbers of hard core unemployed from coverage by the program. Many persons suffering long-term unemployment, for example, do not fit the statutory definition of "disadvantaged" or are over 25 years of age.

In addition, there is some evidence that a targeting formula keyed to an individual's group status can stigmatize members of the group and can signal employers to avoid hiring them. Firms, the GAO study suggests, have "very negative expectations" about the persons eligible under the WIN and TJTC programs.

Without some form of targeting, however, the potential costs of a wage subsidy become prohibitive. Congress, moreover, was burned badly by the indirectly targeted program it experimented with from 1977 to 1978. Under that program all new employees exceeding 102 percent of the company's 1977 work force qualified for the credit. Politicians who had supported that program in the belief that it would benefit the disadvantaged were embarrassed by the widely circulated stories of big Washington law firms and consulting firms qualifying for the wage subsidy. Targeting, moreover, may be a crude mechanism for controlling displacement, since many employers probably are reluctant to disrupt their normal work force to hire a member of the targeted group in exchange for a temporary subsidy.

Ways to Reduce Targeting Problems

Many potential problems of targeting could be eliminated if the wage subsidy were confined to employees earning hourly wages at or near the minimum wage, set at $3.10 for 1980 and scheduled to increase in 1981 to $3.35. Unfortunately, targeting by wage rate, although attractive to economists, may be unattractive politically. A wage subsidy program that appeared to be channeling the unemployed into deadend, low-paying jobs would have few active supporters on Capitol Hill.

A few analysts have suggested that the problems of targeting and displacement could be alleviated by paying the wage subsidy directly to the employee. If it were done in the form of a voucher to be presented to an employer, who would then cash it in to receive the subsidy, it would still have the image problems of the tax credits. If there were a subminimum wage and the subsidy were paid to the employee to bring his income up to the minimum wage level, at least any WINdfall would go to the presumptively more needy workers.

A Well-Designed Tax Expenditure

Both WIN and the TJTC avoid many of the defects that commonly flow from using the tax system to finance spending programs. First, by making the subsidy a credit, it is worth the same dollar amount in tax savings to every employer with the same number of eligible employees. If the subsidy were provided in the form of a deduction, higher-bracketed taxpayers would receive greater tax savings for the same amount of eligible wages than would lower-bracketed taxpayers.

Another improvement from a tax policy standpoint is requiring that the credit be subtracted from the amount of wages deducted for business expenses. Also, the "sunset" provision in the TJTC will prevent it from [*310] continuing unnoticed past the automatic 1981 termination date. Finally, the specific appropriation of funds for the Department of Labor to administer the TJTC program ($10 million for 1979 and $14 million for 1980) suggests that Congress finally has become aware that tax expenditure programs cannot be administered cost-free. The Internal Revenue Service, which shares the administrative responsibility for the TJTC, did not get a special appropriation, however.

The tax credits are a relatively small part of the WIN program, which consists primarily of direct services. There is no separate accounting in the $485 million fiscal 1980 WIN budget for the cost of administering the tax credits.

A direct expenditure program might have been desirable, though, for two reasons. First of all, most of the maddening complexity of the statutes establishing the WIN and the Targeted Jobs Credit programs are due to the necessity of coordinating the programs with a multitude of essentially unrelated tax code provisions. Second, any wage subsidy program operating through the tax code eliminates virtually all managerial discretion, an unhappy design feature in an experimental program aimed at solving a problem no one adequately understands.

Investing in Human Capital

Despite their design problems, the wage subsidy programs are clearly superior, from the point of view of labor, to the alternative of additional tax subsidies for investment. The effect of a wage subsidy is to encourage the use of otherwise unproductive human capital. Investment in human capital is at least as important to increasing the economic growth rate as is investment in physical assets. U.S. tax policy, though, has created a bias for machines over people.

Wage subsidies, which can give the employer many of the cash- flow benefits of a capital subsidy, provide a tiny counterweight to this anti-labor bias. They also tend to funnel benefits to low-income persons. On the other hand, defects in capital investment subsidies traditionally advantage the well-to-do.

When Cinderella, after four years of graduate work in economics, was asked for an opinion about her much-maligned stepmother, she replied: "Compared to what?" This compared-to-what thinking provides the best defense for the wage subsidy programs. The 1977 new jobs tax credit, precursor of the TJTC, was adopted by Congress as a substitute for a Senate Finance Committee proposal to increase the investment tax credit to 12 percent from 10 percent. With a higher investment credit as the alternative, the defects in the jobs tax credits must look picayune to those who give high priority to the job creation and distributional impacts of federal spending programs.